



Saving crumbling enterprises

"While the government struggles to save one crumbling enterprise at the expense of the crumbling of another, it accelerates the process of juggling debts, switching losses, piling loans on loans, mortgaging the future and the future's future. As things grow worse, the government protects itself not by contracting this process, but by expanding it." ¹

I almost want to leave my monthly views at that, nothing more needs to be said.

I think a point everyone misses (unless you have lived through hyperinflation) is that it is possible, even likely, that if you fight deflation with inflationary tools, all you get is inflation and deflation coexisting, the worst of all worlds. What you own or have the capacity to earn does not rise as fast as your expenses. You have to run to stand still.

As we speak, what we own, predominantly held by the older, richer segment of society is going up. However for the rest they have to still earn it. Society's capacity to earn has been, rightly or wrongly, severely eroded by current economic policy and nature.

All the while, expenses are rising even in the face of significant deflation.

So what now?

Bond and equity markets are effectively underwritten by the central banks and their ability to cover any losses with additional credit.

So is a 60/40 traditional equity bond portfolio the correct positioning? No need for a defence strategy when your brother is the biggest bully in the playground? What could go wrong?

Deflation is not a problem at least notionally, the central bank almost relies on deflation these days to justify its policy. And there is absolutely no limit to the amount of deflation/depression that the central banks can't match dollar for dollar.

The stealth enemy is...inflation. Financial or non-financial.

A runaway equity market to the upside is problematic as current policies are no longer justifiable.

Inflation in real goods and services mean that central banks will feel the pressure of maintaining their twin mandate, stability and low inflation. They will need to act...or not.

If they respond by raising interest rates, the 60/40 traditional portfolio will be decimated. I.e. both equities and bond prices will likely go down...a lot.

If they choose to leave interest rates unchanged in the face of significant inflation, the currency will be trashed and so will the real value of a 60/40 portfolio.

I seem to remember that the whole market capitalisation of the Zimbabwe stock exchange, in spite of being the world's best performer, was less than 100 million US dollars at the height of the hyperinflation.

So from where I sit, a traditional portfolio is a first class ticket on the Titanic.

The good news is that worthwhile hedges do exist for the prescient but only in the unloved asset classes.

Currencies, commodities and volatility.

It is here where I think not only the risk transfer will flow, but so too will opportunity.

Central banks are not able to effectively control both their interest rates and their currency rates for any sustained period of time. They, by and large, have picked interest rates as their policy tool of choice, leaving currencies to find their own level. Their use of swap lines between countries will serve to dampen movement locally but only to the point where central banks feel comfortable extending credit to other countries. Tear down that wall and there will be huge uncertainty and movement.

¹ 1974 by Ayn Rand. Egalitarianism and Inflation - The Ayn Rand Letter.

Commodities are poised to gain from any dollar weakness. Any commodity denominated in USD has two big drivers, the supply and demand of the commodity in question and the supply and demand of the currency it is denominated in. The massive supply of dollars to fund the policy choices regarding Covid-19 will ensure commodity prices are underpinned.

Volatility is the price of uncertainty. Currency volatility is at or near decade lows reflecting the perception that central banks will extend to their respective currency and thus protect it from larger than normal movement.

On this point I am happy to disagree with Mr Market and buy long dated currency volatility. The combination of unstable macro backdrop and the ability to invest for a longer time frame gives us enough time to be right, and low in-prices is what we wait for.

Then it is just a question of time.

Disclosure

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